

Theory of the Firm: Monopolistic Competition

Definition:

Monopolistic competition is a market structure in which there are a large number of firms making similar products. (add a couple more of the assumptions from below to ensure a full definition). This form of market structure is common in the service sector, for example barbers, bars and small retailers.

Assumptions of the model:

- A large number of firms each with an insignificant share of the market.
- Products are similar but not unique. That means each firm's product is _____ from those of its competitors. This means there can be some customer loyalty to a particular seller. For example, bars tend to offer the same products but differentiate themselves by offering food, sport on TV, a pool table.
- There are no or very low barriers to entry. Firms do not require large scale capital investment to enter the industry and there are few sunk costs.
- Firms seek to gain extra customers by advertising, which will be on a relatively small scale and by improving the good/service they offer.
- When firms decide on their pricing and output strategy they will not be concerned about how rivals will react.
- It is assumed that firms are profit maximisers and so they will produce where _____

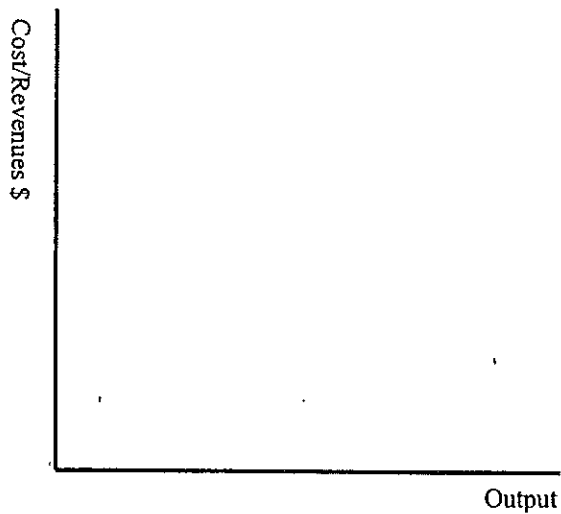
Although there are many different firms in a monopolistic competitive industry, as each one is selling a differentiated product, each has some limited control over price. Therefore these firms are not price _____ but price _____: they can raise prices without losing all of their customers and they must lower prices if they want to sell more. This means that the firm's average revenue will fall with output and will be equal to the firm's demand curve. The demand curve will be relatively price elastic (compared to that of a monopolist) as the products on offer by competitors will be relatively close substitutes.

Short run equilibrium

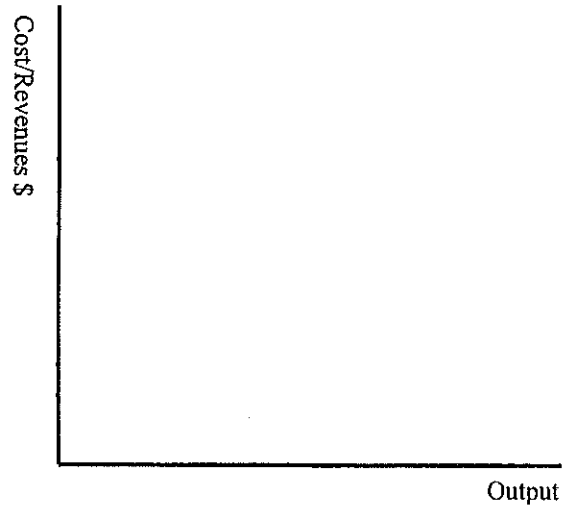
In the short run firms may experience supernormal profits or normal profits or losses. As with perfect competition, supernormal profits will arise if there is a fall in costs or increasing demand. The figure on the left overleaf shows a firm making supernormal profits. It is producing where $MC=MR$ and where $AR>AC$.

The figure on the right shows the same firm which has experienced a rise in costs. It is still producing where $MR=MC$ but in this case the AC curve is above the AR curve at all output positions and the firm is minimising losses.

Supernormal profits under monopolistic competition



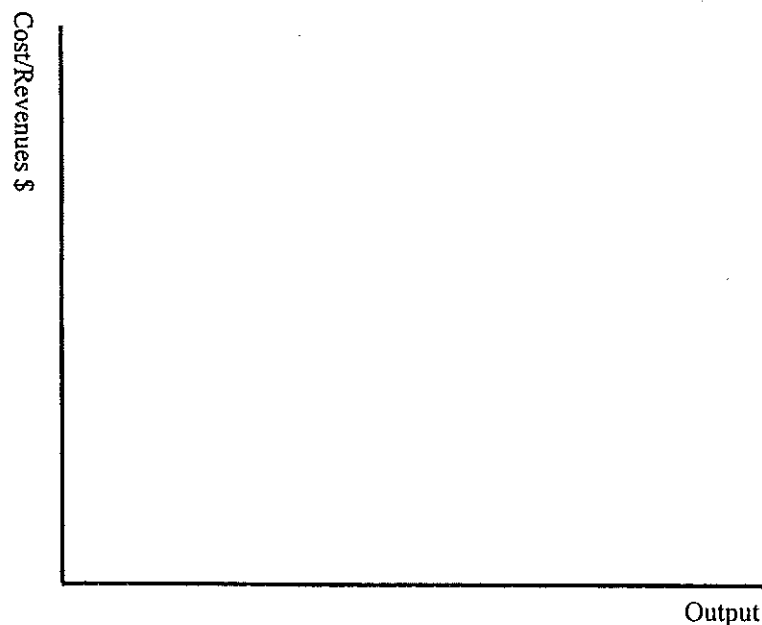
Loss under monopolistic competition



The long run equilibrium position

As there are no or low barriers to entry or exit i.e. very little to prevent firms entering or leaving the industry, normal profits will be earned in the long run. The existence of supernormal profits will attract new firms into the industry. This will cause supply to increase, price to fall and profits to return to the normal profit level. As the supply in the industry increases, the demand for the products of any one firm will fall. For this situation the demand curve (AR) will begin to shift to the left and subsequently the MR curve will also shift to the left.

The figure below shows the long run equilibrium position where $MR=MC$, $AC=AR$, and $AC=AR > MC=MR$.



Efficiency in monopolistic competition

Prices under monopolistic competition are higher than under perfect competition and quantities are lower. Price is greater than marginal cost. Therefore *allocative efficiency* is not achieved in monopolistic competition (price does not equal marginal cost). In addition, *productive efficiency* is not achieved by any firm in monopolistic competition as the firm will not produce at the lowest point on its AC curve.

Comparisons between monopolist competition and perfect competition

Monopolistic competition is similar to perfect competition in the number of ways. The market structures contain many buyers and sellers although the number is less in monopolistic competition. In both cases firms are *profit* _____ and because of the absence of barriers to entry and exit will earn _____ profits in the long run.

However, there are a number of key differences. Firms in monopolistic competition are *price* _____. Whereas firms in perfect competition are *price* _____.

Firms in monopolistic competition face _____ demand for their goods or services whereas in perfect competition the demand for firms' products is perfectly _____.

There is a small degree of *product* _____ in monopolistic competition and firms operating in this market structure can offer consumers a diversity of products. This feature may be seen to be an advantage of monopolistic competition.

However, firms producing under conditions of perfect competition produce at the bottom of the average cost curve in the long run, whereas firms operating under conditions of monopolistic competition produce where average costs are falling and there is spare capacity. Not only do they not achieve _____ efficiency they also do not achieve _____ efficiency.

CASE STUDY

A taxi company, HiCabs, operates in the centre of Birmingham. It employs seven drivers and operates six cabs. There are thirty one other taxi companies operating in the city.

HiCabs' taxis have a distinctive red and yellow livery. To attract more customers the company has recently run an advertising campaign in local Birmingham newspapers. It is considering cutting its fares to attract more customers and has paid a company to carry out market research into the local taxi market. A summary of its findings about consumers' demand for taxi travel is given below.

Elasticities of demand for local taxi travel

Price	Cross	Income
1.2	0.7	2.8

- a] To what extent does HiCabs appear to be operating in a monopolistically competitive market? (7)
- b] Does the cross elasticity of demand figure suggest travel in other taxi firm companies is a close or distant substitute? (5)
- c] What are the other substitutes for taxi travel? (6)
- d] Using the information given, comment on the pricing policy HiCabs should use if it wants to increase the revenue of the firm. (6)
- e] Comment on the significance of the income elasticity of demand figure. (6)
- f] How could a firm assess whether an advertising campaign has been successful or not? (6)
- g] What effect will an advertising campaign be likely to have on a firm's costs in the short and long run. (8)
- h] Discuss two measures, other than advertising and price changes, which HiCabs could take to attract more customers. (6)

STRUCTURED ESSAY

- a] Explain why firms operating under conditions of monopolistic competition are price makers. (5)
- b] Distinguish between perfect competition and monopolistic competition. (20)

FREE RESPONSE ESSAY

Discuss the significance of an absence of barriers to entry and exit for perfect competition and monopolistic competition. (25)